CREATING *and* GROWING

REAL ESTATE WEALTH

The 4 Stages to a Lifetime of Success

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What Kind of Organization Should You Build?

The stories of our protagonists in this book are separated into two chapters. The first focuses on players in the field who stay relatively small, while the second is about those whose businesses grow substantially larger. It's not obvious why people end up in one group rather than the other. Both groups include people who are successful and others who are not so successful. Few start out with a clear vision of where they expect to end up. It's safe to say, though, that multiple factors are at work: personality, opportunity, timing, luck, and inclination.

It is up to you to decide where you want to go with your business. What personnel are needed? What will be your role, and how does it fit you personally?

The vast majority of real estate firms not only start small, they *stay* small. The staff generally consists of an owner, a bookkeeper, a property manager, and perhaps a project manager hired on a temporary basis to carry out a specific development. The owner tends to be involved not only in major decisions, but also most minor ones.

If you do not know how many or what type of deals will be done in your shop in a given year, or who will have what responsibilities, *the fewer personnel commitments you make, the better.* Flexibility is key, especially if you are short on cash. As I said earlier, joint venturing—that is, finding partners appropriate for a specific deal, who have local knowledge or a specific skill—is very common. The trade-off, of course, is shared ownership and control.

If you do not have fee income to cover added staff, it comes out of your pocket. If your goal is to build your capabilities to access and carry out deals, however, you might have to bite the bullet. Good people may cost more, but they generally more than pay for themselves. Don't try to buy people on the cheap. Most have families to support, and cash today has to be their priority. Otherwise, they will not be happy campers for very long, and someone will steal them away.

Often individual entrepreneurs will hire a junior associate who is willing to trade cash for experience. The challenge is to find someone who is adaptable and who will be a quick learner, not just someone who will work for a pittance. The ability to recognize the potential in young people can be a real plus at all stages of your career.

There's no one right way to grow your organization as you scale up. Most entrepreneurs I speak to talk a good game about their willingness to delegate. (Almost everyone claims to be the exception to the rule that entrepreneurs are biologically incapable of delegation.) But successful delegation is not just letting go of the reins. It involves allocating time to hire great people, giving them good guidance, and then leaving them alone to do their jobs. It involves being optimistic enough to assume that others follow your lead, but also realistic enough to *follow up* on those people.

The bottom line is this: *Do you really care for people and how they grow?* If you only see them as a means to an end, or a way of serving your purposes, it won't work. Stay with the small organization. If you decide to accept partners, understand that they will want to be partners in more than name only. They will want to build their own name and reputation, as well as their personal balance sheet.

This can be a serious problem as you grow your organization, especially if you want to hire good people who are capable of taking on responsibility. Management of others is time-consuming, requiring more meetings and more willingness to understand the professional and personal needs of your associates. It is even more complicated if you open field offices in other cities. You will want to maintain control of acquisition, disposition, and financing decisions, but the rules about which other decisions need prior approval from you or your central office tend to get fuzzy. Talk it through in advance with those affected. Misunderstandings lead to not only bad decisions, but also to resentments that can tear apart organizations.

Over time, as your younger people develop, or as their relative value to your business increases, you may want and need to make adjustments to each person's percentage interest. On paper, this is easy to do if you rework the percentages on new deals, grandfathering interests in prior ones. But sitting down and explaining your decision to someone whose shares are being cut back is rarely easy. The reallocated shares may have to come from you—the founder—with or without help from your other senior officials. Transparency and good communication are crucial. The amount of the compensation is important, but people also want to feel they are being treated fairly.

Sharing ownership is complicated. To attract, motivate, and retain good people, you can give them shares in your management company (the entity that receives fees and promotional shares from all the ventures you undertake). Another option is to give equity shares, or lend them money to make investments in projects that they may work on. One potential problem in giving ownership interests is that the people whom you bring in at the time you start your company may not be the ones you need as your company grows or changes direction. *Times change. Retain flexibility.*

You also have to agree on what happens to the interest of someone who leaves or is fired. You likely do not want that person to continue as a shareholder in your company's new deals or those in process. In completed projects, there might be no compelling reason *not* to let the person continue as a limited partner. But, if you want the person out, you prefer it to be done quickly without litigation.

By establishing vesting periods and buyback arrangements, you can protect yourself somewhat, but such mechanisms have to be in place from the beginning. As an owner, be aware that how you handle such situations impacts how others will think about working with you.

From the other side of the fence, if you're an employee, you want to make sure that you don't lose what you have earned if you are let go without valid cause. Good attorneys can suggest workable options.

Where Do You Get the Money?

As you scale up, one of your key constraints is almost certain to be access to capital, both for debt and equity.

In your first deal, you tend to cobble together funds from friends, relatives, and your own savings. As the deals and associated cash requirements get larger—often with longer time frames and varying levels of risk—you most likely will have to expand your base of investors and find new avenues for raising money.

Most of us who finance our small-sized projects individually will continue to look for wealthier investors who can put up the sums we need to finance our expansion. Others with larger aspirations establish commingled funds that give them the freedom to move more quickly to acquire properties. Others go the public route, establishing Real Estate Investment Trusts (REITs).[1] Even if you are not large enough to take advantage of these options, be aware of them. You may find a new set of well-heeled competitors on your block with the resources to outbid you.

Aligning your priorities with those of your investors is important. If you, as the promoter, are rewarded for success only after your investors get their money back plus a preferred return, will your incentive be to sell more quickly? Are you/your investors willing to wait a long time to achieve your "payday?" If the goal is to hold the property for the longer term, how will you be compensated in the meantime? On the flip side, if your total compensation is based on your assets under management rather than profits, will you take advantage of timely sales or hold to collect your fees?

Refinancing is one way to return capital to investors earlier, and without immediate tax consequences. The downside for the promoter is that the added carrying charges may reduce the cash flow on which the promoter's share is calculated. It is a complicated but important subject, with no easy answer. Again, though, you should understand the variables. When raising capital, you also have to focus on the debt side. Up until now, we have been discussing raising equity. You have to decide how much leverage is available to you, and at what cost, as well as the level of risks you are willing to take at that particular time.

The overall state of the financial markets is crucial in this regard. With the globalization of markets, there is much more capital wanting to invest in real estate. Hedge funds, commingled funds, and REITs have been formed to accommodate institutional and foreign investors. Interest rates are relatively low. Lenders are making bigger loans, and due to increased competition are advancing higher percentages of value. Even more important, they are generous in their determinations of value—that is, the appraisals upon which they determine how much they will lend. For the same property, a 70 percent loan may be worth $700,000 to one lender, whereas the other may see it as $770,000, depending on whether the property is valued at $1 million or $1.1 million.

The increase in competition to acquire properties drives up prices. Those who have bet on a rising market have been winners in recent years, although the many sellers happy to bank the proceeds may prove to be the eventual winners as capitalization rates return to more normal levels.

Still, it is not just macroeconomics. If you upgrade your property with long-term leases from higher-quality tenants, your property becomes more financeable and valuable. Sometimes you can find corporations that want to liquify their assets, removing what may be an undervalued, illiquid asset on their balance sheet by selling and leasing back their property. If the credit is good, lenders will often lend you virtually all your purchase price.

The lender in a development project sometimes may lend you the money you need for construction, allowing you to contribute the land at an appreciated value as your equity. This is more likely to occur if you have rezoned the land or pre-leased the property. Normally, however, lenders want you to have some of your own cash in the deal.

As a rule, the *purpose* of your investment should affect the amount of leverage you are willing to take. If your goal is to generate regular cash distributions to distribute to yourself or to your investors, you may want to reduce your leverage, giving you more cash flow to maintain your distributions in a downturn.

On the other hand, if you are short of cash starting out, you may want to borrow as much as possible to maximize your share of the enterprise. This is understandable, but can be risky, especially in development deals where your cash needs are less certain.

If leasing the property takes longer than you expect, or the rents come in below your projections, high financing costs may overwhelm you. If you need additional cash to cover unanticipated expenses, you might not want or be able to go back to your financial partners for more money. As I said earlier, if and when your existing or new investors think they have you over a barrel, they may suddenly demand onerous terms.

As you become successful and build your own (or your company's) balance sheet, you may be able to increase the amount lenders will give you if you guarantee their loan personally, or if you are willing to provide additional security in the form of liens on your other assets. It is easy to advise against doing this, but you might not have a choice. Some lenders require guarantees for at least a portion of the loan, especially during the construction period.

There is another risk you should be aware of. In recent years, lenders are especially wary of potential environmental violations for which some courts have ruled that the lenders might be liable. Lenders may want you to guarantee personally any such exposure. The cost of cleaning up a polluted site can be considerable, and the regulations governing what are considered "acceptable" levels of pollution have gotten stricter. You might consider taking out environmental liability insurance, which covers certain eventualities, albeit at a cost.

Government financing may be available, especially for projects that serve a public purpose. Some of these programs provide interest rate subsidies or other types of subsidies to bring down the cost of housing for lower- and moderate-income families. Loan guarantees from a public authority may allow the developer to borrow more, reducing the amount of equity required. In both cases, this enables otherwise uneconomical projects to be built for an underserved market.

Tax credits have been legislated to encourage the rehabilitation of historic properties, the construction of subsidized housing, and the concentration of commercial and industrial properties in certain urban areas.[2] Tax laws are also written to allow the deferral of capital gains taxes due upon what otherwise would be a sale through the trading of similar (or "like-kind") properties. Congress also sets depreciation schedules that affect the amount of noncash deductions you can take on an annual basis against the other income from your property.

Not all these policies work out as planned. At one point, lenient tax policies with accelerated depreciation schedules for newly constructed projects attracted investors to the field who had little interest in the cash flow from the property itself. Buildings were developed where there was no need, and the subsequent oversupply destroyed property values in many markets.

But this, in turn, created opportunities. Lenders who wound up with distressed properties often sold them at much discounted prices. For patient buyers who had cash, many fortunes were made.

In any case, *watch what is happening in Washington.* The government might actually be helping you; if so, you should know about it. Many real estate–related organizations and accounting firms publish newsletters that can help keep you up-to-date.

The bottom line is that we all know there are risks involved in leverage. On the other hand, the ability to leverage is one of the